This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 02 ISTANBUL 000777

SIPDIS

SENSITIVE

STATE FOR E, EUR AND EB
TREASURY FOR U/S TAYLOR AND OASIA - MILLS
NSC FOR QUANRUD AND BRYZA

E.O. 12958: N/A
TAGS: ECON EINV PGOV TU
SUBJECT: TACKLING TURKEY'S PRODUCTIVITY GAP: MICRO MATTERS

Sensitive but Unclassified - not for internet distribution.

¶1. (SBU) Summary: While most attention in Turkey remains focused on the country's macroeconomic fundamentals, a new McKinsey Global Institute report is directing attention to the productivity gap that separates Turkey from the U.S. and Europe and the microeconomic reforms that must be taken to close it. Highlighted are the need to reduce the high level of informality in the Turkish economy, to ensure that liberalization of utilities occurs only in a "robust" regulatory and judicial environment, and to redouble efforts to smooth economic volatility. End Summary.

¶2. (SBU) Lagging Productivity: The McKinsey study, 15 months in the making, estimates that overall productivity levels in Turkey are just one-half of their potential, averaging 40 percent of U.S. levels for labor, and 50 percent overall. The estimate reflects both low total factor productivity (at Korea's level) and a declining level of total factor inputs (more akin to Brazil) over the last decade. The overall figure masks the key attribute of the Turkish economy, however: bi-modality, whereby modern and traditional/informal sectors uneasily coexist in particular industries. In the modern sector productivity can approach 65 percent of the U.S. level, in traditional areas it is less half that. Normally such inefficient firms would be squeezed out of the market, but because of the "unfair" advantages they receive by operating "informally" and avoiding tax, social security and regulatory requirements, they are able to stay in business. While conceding that structural impediments make it unrealistic for Turkey to reach U.S. productivity levels in the medium term, the report argues that Turkey could reach 70 percent of U.S. levels if it adopted the correct policy mix. Such a course, McKinsey argues, could unleash growth averaging 8.5 percent a year from 2005-2015, and create 6 million new jobs (coincidentally matching the number a recent TUSIAD report estimated must be created to put Turkey's worsening unemployment dynamics on a positive track).

¶3. McKinsey's Action Plan: Arguing that Turkey is fortunate in that it does not suffer "death from a thousand cuts," McKinsey argues that its three highlighted factors explain over 90 percent of Turkey's productivity shortfall. To address them, it pushes for the following:

-- Informality: McKinsey recommends a carrot and stick approach to give firms now operating in the shadow economy an incentive to move into the modern sector. While Turkey's ability to offer "carrots" is constrained by its need to maintain a strong primary surplus to support the IMF reform package (though the study notes that if VAT fulfillment rose from 64 to 90 percent, the rate could be lowered from 18 to 13 percent without any impact on revenue), McKinsey recommends the government facilitate enterprise access to information and know-how, modelled on current EU programs that support SME's. As a stick, the report pushes for stricter and more effective enforcement of company obligations, but concedes that this cannot be done across the board, but must instead be targeted at specific sectors. It suggests starting with the VAT in the retail sector, and then moving upstream and downstream.

-- Monopoly Market Liberalization: McKinsey reiterates the need for Turkey to liberalize its monopoly sectors-- especially telecommunications and electricity-- but stresses that this must be done in an effective and "unambiguous" regulatory and judicial framework. It points to Telecom Italia Mobile's recent difficulties as an example of how a weak regulatory structure has permitted sector incumbents to block a competitive challenge, and the improved productivity such a challenge would bring.

-- Macroeconomic and political stability: McKinsey highlights the distortions that Turkey's recent instability have brought to business operations, and the way in which it has hampered productivity. While at the simplest level Turkey's shifts over the last decade from boom to contraction have made capacity planning virtually impossible, the resultant high interest rates and inflation that have characterized the economy have skewed managerial priorities, putting a higher premium on cash-flow management, for instance, than on operational or productivity improvements. (One contact in the food sector notes that supermarkets in Turkey have routinely earned profits above 20 percent, 2/3's of which stems from their ability to impose 120-day payment terms on their suppliers, rather than from any innate efficiency.)

¶4. (SBU) Positive Reaction: In a meeting with P/E Chief on April 30, McKinsey Director David Meen indicated that reaction to the report in business and industrial circles had been uniformly positive, and that its analysis and conclusions were widely accepted. He conceded that the report had had less impact in Ankara than McKinsey had hoped, given that it appeared in the run-up to the Iraq war, when the capital's attention was directed elsewhere. However, he indicated that the firm has had fruitful contacts with both State Minister Babacan and the Energy and Transportation Ministries regarding its specific regulatory suggestions. Babacan, he said, was particularly intrigued by the suggestions on informality. To raise the report's profile further, Meen said that McKinsey will soon organize a series of conferences in Ankara, with the assistance of the Union of Chambers of Commerce (TOBB). He emphasized, however (and reiterated the point in a May 8 speech at the "Forum Istanbul" conference), that he is waiting to be convinced about the government's commitment to transform words into actions.

¶5. (SBU) Comment: The McKinsey report is well timed, and reaffirms from a productivity standpoint the importance of getting Turkey's macro fundamentals right, while also outlining a number of micro steps that can also bridge another significant part of Turkey's productivity shortfall. Some question whether taking on the informal sector is a wise policy choice, given the important role it has played in cushioning the impact of recent economic crises. But McKinsey makes a convincing case that the virtuous cycle created by reducing informality and improving productivity would ultimately produce income and jobs far outweighing those lost through the informal sector's contraction. End Comment.

ARNETT